Explanatory Notes Relating to Income Tax

Natural Resources

Published by
The Honourable John Manley, P.C., M.P.
Deputy Prime Minister and Minister of Finance

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Canada

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PREFACE

These explanatory notes describe proposed amendments to the *Income Tax Act*. Draft amendments to the *Income Tax Regulations*, with corresponding explanatory notes, are also included.

These explanatory notes describe these amendments, clause by clause, for the assistance of Members of Parliament, taxpayers and their professional advisors.

The Honourable John Manley, P.C., M.P.
Deputy Prime Minister and Minister of Finance

These explanatory notes are provided to assist in the understanding of proposed amendments to the *Income Tax Act*. Draft amendments to the *Income Tax Regulations*, with corresponding explanatory notes are also included. These notes are intended for information purposes only and should not be construed as an official interpretation of the provisions they describe.

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OVERVIEW

1. Introduction

This legislation proposes amendments to the *Income Tax Act* (the Act) to give effect to the new structure for federal income taxation of resource income as announced in the 2003 Budget and the Department of Finance Technical Paper "Improving the Income Taxation of the Resource Sector in Canada" released on March 3, 2003. As described in that paper, the new structure for federal income taxation of resource income consists of the following elements, which will be phased in over a period of five years:

- a deduction for income tax purposes of actual provincial and other Crown royalties and mining taxes paid;
- the elimination of the existing 25-per-cent resource allowance;
- a reduction of the federal statutory corporate income tax rate on income earned from resource activities from 28 to 21 per cent, beginning with a 1-percentage-point reduction on January 1, 2003; and
- a new tax credit at a rate of 10 per cent for corporations incurring qualifying mineral exploration expenditures.

2. Deduction for Crown royalties and mining taxes

The existing tax structure requires the inclusion in income, or disallows the deduction from income, of royalties or mining taxes which are receivable by the Crown or payable to the Crown, as the case may be, under paragraphs 12(1)(*o*) and 18(1)(*m*) of the Act. Depending on the specific royalty or mining tax, resource producers are subject to one of these two provisions. The proposed amendments to the Act have the effect of removing this inclusion in income, or prohibition on deduction, (whichever is applicable) of Crown royalties and mining taxes over a five-year transitional period in the following percentages, which are pro-rated for taxation years that do not match the calendar year:

	2003	2004	2005	2006	After 2006
Percentage of Crown royalties and taxes on resource production required to be included in income, or prohibited from deduction	90	75	65	35	0

This measure is implemented by way of a repeal of paragraphs 12(1)(*o*) and 18(1)(*m*) of the Act (and the associated Regulation 1211) for taxation years that begin after 2006 and a phase out, according to the schedule above, for the 2003-06 years. In addition, a deduction is provided under paragraph 20(1)(*v*) for income taxes on mining. This deduction operates subject to the limitation under paragraph 18(1)(*m*) during the transitional period.

Consistent with other deductions in the Act, a taxpayer that deducts Crown royalties or mining taxes may only deduct the amount of Crown royalty or mining tax actually paid. To the extent that a taxpayer receives a refund of the Crown royalty or mining tax, there is a reduction of the amount actually paid. Where a mining tax has been deducted, a refund of that tax is included in income by virtue of paragraph 12(1)(*x*). New paragraph 12(1)(*x*.2) is proposed in this legislation to ensure that a refund of Crown royalties is included in the income of the recipient in circumstances where the Crown royalty was not included into income, because it represented the Crown's share of resource production. In either case, only the portion of the refund or reimbursement that relates to the deductible (or excluded) portion of the Crown royalty or mining tax, will be included in income during the transitional period.

One the most significant refund programs for Crown royalties is the Alberta Royalty Tax Credit (ARTC). The ARTC is available only to individuals and corporations. Under the ARTC program, the Province of Alberta refunds a minimum of 25 per cent of the first $2 million in Alberta Crown royalties, designed to target the benefits to smaller producers. A special provision is proposed in respect of the income tax treatment of the ARTC, which will reduce, during a ten year transitional phase-in period, the portion of the refund that must be included in income for tax purposes. Specifically, only half of the otherwise includable amount of the ARTC will be included in computing income for tax purposes for calendar years 2003 through 2007. For years 2008 through 2012, the effective inclusion rate will increase by 10 percentage points per year, as follows:

	2003	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**After 2011**
Percentage of ARTC included in income	10 x.5 = 5	25 x.5 = 12.5	35 x.5 = 17.5	65 x.5 = 32.5	100 x.5 = 50	60	70	80	90	100

The special transitional measure will be available to individuals who receive the ARTC, and to taxable Canadian corporations that pay no more than $2 million in Alberta Crown royalties, as defined for ARTC purposes. The benefit of the special transitional measure will be reduced for taxable Canadian corporations that pay more than $2 million in Alberta Crown royalties, as defined for ARTC purposes. This reduction will occur on a straight-line basis such that the benefit is of the additional transition is completely removed for corporate groups that pay $5 million or more of Alberta Crown royalties.

3. Elimination of the Resource Allowance

The resource allowance, calculated as 25 per cent of "adjusted resource profits" as defined in Regulation 1210, is phased out such that a declining percentage of the allowance will be deductible in determining income subject to tax. These percentage amounts are effective as of January 1 of each year and are pro-rated for corporations with taxation years that include days in more than one calendar year. The deductible percentage of the resource allowance matches the amount of Crown royalties and mining taxes that are disallowed as a deduction or included in income, as follows:

	2003	**2004**	**2005**	**2006**	**After 2006**
Percentage of resource allowance deductible in computing income:	90	75	65	35	0

This measure is accomplished by the repeal of paragraph 20(1)(*v*.1) of the Act, and its associated Regulation 1210, effective for taxation years after 2006. For years from 2003-06, the amount deductible is reduced according to the schedule above. The corresponding inclusion for a resource loss, which is included in income under paragraph 12(1)(*z*.5) of Act, is phased out and removed (including the associated Regulation 1210.1) on the same schedule. During the transitional period, the resource allowance, and adjusted resource profits, will continue to be calculated as though Crown royalties and mining taxes were 100% non-deductible, such that the resource allowance computation itself will not change during the transitional period.

4. Reduction in the Corporate Tax Rate

The federal statutory corporate income tax rate on income earned from resource activities will be reduced from 28 to 21 per cent by 2007. The federal corporate income tax rate reductions will be effective on January 1 of each year and will be pro-rated for corporations with taxation years that include days in more than one calendar year. The tax rate reductions begin with a 1% reduction in 2003 as follows:

	2003	**2004**	**2005**	**2006**	**After 2006**
Corporate income tax rate	27	26	25	23	21

During the transitional period, this measure is accomplished by providing a deduction against the existing 28% rate for "taxable resource income" as newly defined in the legislation. This deduction will be provided in new section 125.11 of the Act. After the transitional period, resource income will be treated as "full rate taxable income", as defined in the Act, and will be subject to the general rate reduction rules.

The legislative proposal defines taxable resource income both for the purpose of determining what income is not full rate taxable income and for the purpose of providing the new resource rate reduction for resource income. Taxable resource income is equal to the lesser of taxable income and the amount that is 3 times the corporation's resource allowance for the taxation year (computed as though no reduction had occurred), plus any additions to income in the year by virtue of negative resource pools (CEE, CDE, COGPE), and minus any deductions of resource pools in the year.

5. Mining Tax Credit

The Technical Paper proposed the introduction of a new 10-per-cent tax credit for qualifying mineral exploration expenses. The new corporate mineral tax credit will apply in respect of eligible expenditures made in 2003, at a rate of 5 per cent. The rate will rise to 7 per cent in 2004, and will be fully phased in at a 10-per-cent rate in 2005. The new tax credit is available only to corporations that directly incur eligible expenses, and is not transferable under a flow-through share agreement, allocable by a partnership or trust, or refundable. The credit is otherwise subject to the usual provisions applicable to investment tax credits in the Act.

The new credit will apply to both grass roots exploration and pre-production development expenditures in Canada for qualifying minerals. These expenses are described in paragraphs (*f*) and (*g*) of the definition of "Canadian exploration expense" in subsection 66.1(6) of the Act. Those paragraphs require that the expenses be incurred before a new mine in the mineral resource comes into production in reasonable commercial quantities. Qualifying minerals for the credit are diamonds, base or precious metals, and industrial minerals that become base or precious metals through refining.

6. Other Legislative Amendments

A number of other amendments relevant to the taxation of resource income are included in this legislation.

In particular, provisions of the Act that make reference to the provisions that will be repealed for taxation years that begin after 2006, being paragraphs 12(1)(*o*) and (*z*.5), 18(1)(*m*), and 20(1)(*v*.1), are amended, effective as of that date to remove the reference to those paragraphs. These consequential amendments affect a number of provisions to which amendments were proposed in the December 2002 Draft Technical Income Tax Amendments. In order to maintain consistency in the ordering of the amendments, the amendments to those provisions have been moved from the Draft Technical Legislation to this legislation. **Amendments proposed in the December 2002 Draft Technical Income Tax Amendments that are not affected by this legislation will remain in the Draft Technical Legislation for tabling at a later date**.

In addition, amendments to subsection 66(17) and subparagraphs 66(12.66)(*b*)(i) and (ii), are included in this legislation. These amendments are relevant to the renunciation of expenses under a flow-through share agreement, and replace amendments to those provisions which were proposed in the December 2002 Draft Technical Income Tax Amendments. Among other things, these amendments include Canadian renewable and conservation expenses (CRCE) in the one year look-back rule for flow-through share expenditures, effective for CRCE expenses incurred after 2002 pursuant to a flow-through share agreement entered into after July 26, 2002. This amendment fulfils the commitment announced by Press Release 2002-063, dated July 26, 2002, to enhance the tax incentives for investments in renewable energy and energy conservation projects by allowing corporations to renounce CRCE to flow-through share investors in a year, although the CRCE will be incurred in the subsequent year.

7. Proposed Regulatory Amendments

A number of proposed amendments to the *Income Tax Regulations* (the Regulations) are appended to these Technical Notes. Many of these amendments are simply consequential upon the removal of paragraphs 12(1)(*o*) and (*z*.5), 18(1)(*m*), and 20(1)(*v*.1) from the Act and will be effective only for taxation years beginning after 2006. A limited number of amendments are effective after December 20, 2002 consequential upon amendments proposed in the Draft Technical Legislation.

Certain other proposed amendments to the Regulations are relevant to the transitional period. These amendments include a proposed change to the opening words of Regulation 1210 to permit the transitional phase-out of the resource allowance and a proposed change to Regulation 3900 to permit the deduction of mining taxes based on income and related to the mining of "minerals" as defined in the Act.

One further change, which is proposed to be implemented on a retroactive basis, is a relieving amendment to confirm, for greater certainty, that accelerated capital cost allowance is eligible for qualifying costs incurred in respect of new mines up to the point where the mine comes into production in reasonable commercial quantities.

EXPLANATORY NOTES

Clause 1

Income Inclusions

ITA
12

Section 12 of the Act provides for the inclusion of various amounts in computing the income of a taxpayer from a business or property.

Royalties, etc.

ITA
12(1)(*o*)

Paragraph 12(1)(*o*) of the Act requires a taxpayer to include in income, for a taxation year, amounts that become receivable in the year by the Crown or an emanation of the Crown, in respect of resource production in Canada and the ownership of resource property in Canada. Paragraph 12(1)(*o*) applies where the federal or provincial Crown, or an emanation thereof, has an interest in production from, or ownership of, a mineral resource or an oil or gas well.

As proposed in the December 2002 Draft Technical Income Tax Amendments, paragraph 12(1)(*o*) is amended to eliminate the requirement that the obligation under which the amount becomes receivable, be imposed by statute or by a contractual obligation substituted for an obligation imposed by statute. This amendment, which applies to amounts that become receivable after December 20, 2002, eliminates any interpretive difficulties that may be associated with the phrase "a contractual obligation substituted for an obligation imposed by statute". Exemptions are prescribed by section 1211 of the Regulations for amounts described in paragraph 12(1)(*o*) for which it would be inappropriate to require an inclusion in income.

As announced in Budget 2003 and the Department of Finance Technical Paper "Improving the Income Taxation of the Resource Sector in Canada" released March 3, 2003, the requirement that Crown royalties and taxes on production or resource property ownership be included in income will be removed over a five-year transitional period. To achieve this result, paragraph 12(1)(*o*) is repealed in its entirety for taxation

years that begin after 2006. For years from 2003 to 2006, paragraph 12(1)(*o*) will apply to the following percentage of the total of the amounts otherwise described by that paragraph:

	2003	**2004**	**2005**	**2006**	**After 2006**
Percentage of Crown royalties and taxes on resource production required to be included in income:	90	75	65	35	0

The rate of inclusion of Crown royalties and taxes into income is pro-rated, based on the number of days in each calendar year, for taxation years that do not match the calendar year.

Also announced in the Technical Paper is the phase-out of the resource allowance, which is permitted as a deduction under paragraph 20(1)(*v*.1) of the Act, over the same five year period. The resource allowance is computed in Part XII of the Regulations on an amount that includes Crown royalties and taxes on resource production and property ownership. In order to maintain the same base for the computation of the resource allowance during the transitional period, the graduated reduction in the application of paragraph 12(1)(*o*) does not apply for the purpose of any provision of Part XII of the Regulations that makes reference to the income of the taxpayer.

Crown charge rebates

ITA
12(1)(*x*.2)

New paragraph 12(1)(*x*.2) applies to include a refund of a Crown royalty in the income of the recipient in circumstances where the Crown royalty was not included into income. The background to the introduction of this provision is described below.

Existing paragraph 12(1)(*x*) provides that certain inducements, reimbursements, contributions, allowances and assistance received by a taxpayer in the course of earning income from a business or property must be included in income to the extent that the amounts have not otherwise been included in income or reduced the cost of property or the amount of an outlay or expense.

Two subparagraphs describe inducements or assistance which may apply, *inter alia*, to Crown royalties or mining taxes. Subparagraph 12(1)(*x*)(iii) applies to an inducement and subparagraph 12(1)(*x*)(iv)

applies to assistance in respect of the cost of property or of an outlay or expense. The inducement to which subparagraph (iii) refers is generally designed to induce the taxpayer to undertake an activity which is not simply the payment of the royalty or tax itself. Similarly, the assistance to which subparagraph (iv) applies is generally in respect of the cost of property or of an outlay or expense, which is not the royalty or tax itself. In this form of inducement or assistance, a reduction of a Crown royalty or mining tax, which would otherwise be payable, is simply the means by which the inducement or assistance is delivered to the taxpayer. Since the inducement or assistance is itself valuable to the taxpayer, paragraph 12(1)(*x*) applies to add the inducement or assistance to income regardless of whether the associated outlay or expense was deductible for tax purposes.

Further, paragraph 12(1)(*x*) applies to add the inducement or assistance to income regardless of whether the Crown royalty or mining tax, which was reduced as a means of delivery of the inducement or assistance, was deductible for tax purposes. Therefore, the application of paragraph 12(1)(*x*) to inducements or assistance does not change as a result of the introduction of deductibility from income, or non-inclusion into income, of Crown royalties or mining taxes, proposed in the reform of the taxation of resource income.

Subparagraph 12(1)(*x*)(iv) also applies to include into income a refund or reimbursement of an outlay or expense. Among other things, this portion of that subparagraph includes into income a refund or reimbursement of a mining tax that constituted an outlay or expense of the taxpayer. Since subparagraph 12(1)(*x*)(iv) applies even where the original outlay or expense was not deductible for tax purposes, this provision could result in double taxation of the refund in the case of a mining tax which was not deductible by virtue of paragraph 18(1)(*m*). Subsection 12(2.2), however, provides protection against the potential for double taxation in respect of the reimbursement of an amount that was not otherwise deductible. Subsection 12(2.2) permits the taxpayer to elect to reduce the original outlay or expense to the extent of refund or reimbursement in order to create a set-off of the two amounts.

In the context of the legislative reform to the taxation of resource income, once the prohibition in paragraph 18(1)(*m*) is phased out, a taxpayer may either deduct the gross royalty or tax and include any refund or reimbursement into income under paragraph 12(1)(*x*), or elect to reduce the original deduction to the extent of the refund or reimbursement under subsection 12(2.2). In either case, the result is that

the net deduction that the taxpayer may recognize for tax purposes is limited to the mining taxes paid minus any refund or reimbursement.

Paragraph 12(1)(*x*)(iv) does not apply to a refund or reimbursement of a Crown royalty which is described in paragraph 12(1)(*o*), since the original Crown royalty does not constitute an outlay or expense. Since the income inclusion described in paragraph 12(1)(*o*) is not reduced by any refund or reimbursement, the exclusion of refunds from paragraph 12(1)(*x*)(iv) serves the same purpose as subsection 12(2.2) in the context of mining taxes, namely to avoid double taxation of the refund. However, once the requirement to include the Crown royalty in paragraph 12(1)(*o*) is phased-out or removed, as proposed in this legislation, any refund or reimbursement of that Crown royalty is to be included in income, consistent with the treatment of refunds or reimbursements of mining taxes. New paragraph 12(1)(*x*.2) provides for that result.

There is a lengthy transition for new paragraph 12(1)(*x*.2). The amount to which the new provision applies is to be determined by the formula:

$$[A - (B \times C \times D)] \times E$$

The basic transitional relief, which applies to all taxpayers, is provided by multiplying the total of:

A: all refunds or reimbursements for the year, by

E: the percentage of Crown royalties which is not required to be included into income under paragraph 12(1)(*o*), as that provision is phased-out, as follows

	2003	**2004**	**2005**	**2006**	**After 2006**
E: Percentage of Crown royalties not required to be included in income	10	25	35	65	100

Special additional transitional relief is provided for the Alberta Royalty Tax Credit (ARTC). The ARTC is one the most significant refund programs for Crown royalties and is available only to individuals and corporations. Under the ARTC program, the Province of Alberta refunds a minimum of 25 per cent of the first $2 million in Alberta Crown royalties, designed to target the benefits to smaller producers.

The special transitional relief for the ARTC is provided by reducing A, as described above, by the amount described by the formula

(B x C x D)

In this formula,

B: is the total ARTC received in the year by the taxpayer;

D: is the percentage of ARTC that is excluded from the application of paragraph 12(1)(*x*.2), as follows:

	Before 2008	**2008**	**2009**	**2010**	**2011**	**After 2011**
Percentage of ARTC to be included in income	50	60	70	80	90	100

C: is the amount of special transitional relief available to the particular taxpayer, where 0 is no special transitional relief and 1 is 100% of the special transitional relief.

C is 1 for individuals and 0 for all other taxpayers other than taxable Canadian corporations. For a taxable Canadian corporation, C will be between 1 and 0 depending on the amount of Alberta Crown royalty paid in the taxation year by the group of related corporations to which the corporation belongs. Where the Alberta Crown royalty is $2 million or less, C will be 1. C will be reduced to 0 on a straight-line basis where the Alberta Crown royalty paid by the corporate group rises from $2 million to $5 million in the year.

The net result, for individuals and taxable Canadian corporations fully eligible for the special transitional relief is that the amount of ARTC subject to the new income inclusion rule is as shown in the chart below:

	2003	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**After 2011**
Percentage of ARTC included in income	10 x.5 = 5	25 x.5 = 12.5	35 x.5 = 17.5	65 x.5 = 32.5	100 x.5 = 50	60	70	80	90	100

Resource loss

ITA
12(1)(*z*.5)

Paragraph 12(1)(*z*.5) of the Act was introduced in 1996 to provide for symmetrical treatment of profits and losses from resource activities. Paragraph 12(1)(*z*.5) includes 25% of a taxpayer's resource loss for a taxation year, as prescribed by Regulation 1210.1, into the income of the taxpayer for the year. The provision is repealed, together with Regulation 1210.1, for taxation years after 2006. For the 2003 to 2006 years, the 25% percent inclusion rate is reduced to a percentage equal to the deductible portion of the resource allowance (under paragraph 20(1)(*v*.1)) for the year, as follows:

	2003	**2004**	**2005**	**2006**	**After 2006**
Percentage of resource loss to be included in computing income:	25% x 90% = 22.5%	25% x 75% = 18.75%	25% x 65% =16.25%	25% x 35% =8.75%	0%

The reduction of the resource loss inclusion is pro-rated, based on the number of days in each calendar year, for taxation years that do not match the calendar year.

Clause 2

Prohibited Deductions

ITA
18

Section 18 of the Act prohibits the deduction of certain outlays and expenses in computing a taxpayer's income from a business or property.

***Petroleum and Gas Revenue Tax Act* payments**

ITA
18(1)(*l*.1)

Paragraph 18(1)(*l*.1) of the Act prohibits the deduction of amounts payable by virtue of an obligation imposed under the *Petroleum and Gas Revenue Tax Act*. This provision is repealed, effective December 20, 2002 and consequential upon the repeal of the *Petroleum and Gas Revenue Tax Act*.

Royalties, etc.

ITA
18(1)(*m*)

Paragraph 18(1)(*m*) of the Act prohibits a taxpayer from deducting from income, for a taxation year, amounts that become payable in the year to the Crown or an emanation of the Crown, in respect of resource production in Canada and the ownership of resource property in Canada. Paragraph 18(1)(*m*) applies where the interest in production from a Canadian resource property or in the Canadian resource property itself is privately owned.

As proposed in the December 2002 Draft Technical Income Tax Amendments, paragraph 18(1)(*m*) is amended to eliminate the requirement that the obligation under which the amount becomes payable, be imposed by statute or by a contractual obligation substituted for an obligation imposed by statute. This amendment, which applies to amounts that become payable after December 20, 2002, eliminates any interpretive difficulties that may be associated with the phrase "a contractual obligation substituted for an obligation imposed by statute". Exemptions are prescribed by section 1211 of the Regulations for amounts described in paragraph 18(1)(*m*) for which it would be inappropriate to prohibit a deduction from income.

As announced in Budget 2003 and the Department of Finance Technical Paper "Improving the Income Taxation of the Resource Sector in Canada" released March 3, 2003, the prohibition on the deduction of Crown royalties and taxes on production or resource property ownership will be removed over a five-year transitional period. To achieve this result, paragraph 18(1)(*m*) is repealed in its entirety for taxation years that begin after 2006. For years from 2003 to 2006, paragraph 18(1)(*m*)

will apply to the following percentage of the total of the amounts otherwise described by that paragraph:

	2003	2004	2005	2006	After 2006
Percentage of Crown royalties and taxes on resource production not deductible in computing income:	90	75	65	35	0

The rate of inclusion of Crown royalties and taxes into income is pro-rated, based on the number of days in each calendar year, for taxation years that do not match the calendar year.

As the prohibition on Crown royalties and taxes on resource production and the ownership of resource property is phased-out and removed, those royalties and taxes will become deductible, subject only to the usual limitations on an expense deducted for tax purposes in accordance with section 9 of the Act. The only significant common law restriction on the deductibility of the amounts described in paragraph 18(1)(*m*) is that taxes on income are not generally considered to be incurred for the purpose of gaining or producing income and are therefore prohibited from deduction as a result of paragraph 18(1)(*a*): *Quemont Mining Corp. Ltd. et al. v. M.N.R.*, [1967] 2 Ex. C.R. 169, aff'd [1970] S.C.R. 511 and *Teck Corporation v. HMTQ* 2002 BCSC 1459.

In order to overcome this restriction, Crown royalties and taxes on resource production which are computed by reference to income will be deductible (subject to the phase-out of paragraph 18(1)(*m*)) under paragraph 20(1)(*v*) after 2002. This is accomplished by removing the restrictive definition of "minerals" for the purposes of section 3900 of the Regulations, with the result that the definition of minerals in subsection 248(1) of the Act will apply in Regulation 3900. Since section 20 of the Act only overrides the restrictions imposed by paragraphs 18(1)(*a*), (*b*) and (*h*), but not (*m*), paragraph 20(1)(*v*) will operate subject to the phase-out of the restriction in paragraph 18(1)(*m*) during the transitional period.

Also announced in the Technical Paper is the phase-out of the resource allowance, which is permitted as a deduction in paragraph 20(1)(*v*.1) of the Act, over the same five year period. The resource allowance is computed in Part XII of the Regulations on an amount that includes Crown royalties and taxes on resource production and property ownership. In order to maintain the same base for the computation of the resource allowance during the transitional period, the graduated reduction in the application of paragraph 18(1)(*m*) does not apply for

the purpose of any provision of Part XII of the Regulations that makes reference to the income of the taxpayer.

Clause 3

Deductions

ITA
20

Section 20 of the Act provides rules relating to the deductibility of certain outlays, expenses and other amounts in computing a taxpayer's income for a taxation year from business or property.

Resource allowance

ITA
20(1)(*v*.1)

Paragraph 20(1)(*v*.1) of the Act permits a taxpayer, in computing income for a taxation year, to deduct a "resource allowance" in respect of mineral resources and oil and gas wells in Canada. The resource allowance is computed in section 1210 of the Regulations. As announced in Budget 2003 and the Department of Finance Technical Paper "Improving the Income Taxation of the Resource Sector in Canada" released March 3, 2003, the resource allowance will be removed over a five-year transitional period. This removal operates *in tandem* with the removal of the inclusion into income of, or prohibition on the deduction of, Crown royalties and taxes on production or resource property ownership over the same period.

To achieve this result, paragraph 20(1)(*v*.1) is repealed in its entirety for taxation years that begin after 2006. For years from 2003 to 2006, the "resource allowance" will be computed in the Regulations in same manner as for 2002, but paragraph 20(1)(*v*.1) will apply to permit the deduction of only the following percentage of the total of the resource allowance amounts determined by section 1210 of the Regulation:

	2003	**2004**	**2005**	**2006**	**After 2006**
Percentage of resource allowance deductible in computing income:	90	75	65	35	0

The reduction of the resource allowance deduction is pro-rated, based on the number of days in each calendar year, for taxation years that do not match the calendar year.

Regulations

ITA
20(15)

Subsection 20(15) of the Act is a special interpretive provision which permits section 1210 of the Regulations, which applies for the purposes of paragraph 20(1)(*v*.1) of the Act, to prescribe the amount deductible as a "resource allowance" under that paragraph. This subsection is repealed for taxation years that end after 2002 as a consequence of the phase out of the "resource allowance", to confirm that the amount deductible will be determined under the phase-out of paragraph 20(1)(*v*.1), as amended.

Clause 4

Exploration and Development Expenses

ITA
66

Section 66 of the Act provides rules in respect of Canadian and foreign exploration and development expenses.

Expenses in the First 60 Days of the Year

ITA
66(12.66)

Subsection 66(12.66) of the Act permits a corporation to renounce Canadian exploration expenses ("CEE") and Canadian development expenses ("CDE") to a flow-through shareholder within defined limits. Where the conditions described in subsection 66(12.66) are met, the corporation may renounce in January, February or March of a particular calendar year, effective as of the end of the preceding calendar year, the expenses described in subsection 66(12.66) that the corporation has incurred, or plans to incur, in the particular year. In other words, subsection 66(12.66) provides a "look-back" period of one year.

ITA
66(12.66)(*b*)(i) and (ii)

Paragraph 66(12.66)(*b*) of the Act describes those expenses eligible for renunciation in the look-back period. The expenses described by subparagraph 66(12.66)(*b*)(ii) are expenses that 'would be described in paragraph (*h*) of the definition "Canadian exploration expense" in subsection 66.1(6) of the Act if the expression "paragraphs (*a*), (*b*), (*c*), (*d*), (*f*) and (*g*)" in that definition were read as "paragraphs (*a*), (*d*) and (*f*)"'. The wording in subparagraph 66(12.66)(*b*)(ii) is consistent with paragraph (*h*) of the definition "Canadian exploration expense" in subsection 66.1(6) as that paragraph read before December 6, 1996. After December 5, 1996, paragraph (*h*) of the definition contains a reference to paragraph (*g*.1) of the definition.

As proposed in the December 2002 Draft Technical Income Tax Amendments, subparagraph 66(12.66)(*b*)(ii) is amended, effective after December 5, 1996, as a consequence of the 1996 amendment to paragraph (*h*) of the definition "Canadian exploration expense".

Subparagraphs 66(12.66)(*b*)(i) and (ii) are also amended to include Canadian renewable and conservation expenses (CRCE) in the one year look-back rule. This amendment fulfils the commitment announced by Press Release 2002-063, dated July 26, 2002, to enhance the tax incentives for investments in renewable energy and energy conservation projects by allowing corporations to renounce CRCE to flow-through share investors in a year, although the CRCE will be incurred in the subsequent year. The amendment is effective for CRCE expenses incurred after 2002 pursuant to a flow-through share agreement entered into after July 26, 2002.

Definitions

ITA
66(15)

Subsection 66(15) of the Act contains various definitions for the purposes of section 66.

"Canadian resource property"

A "Canadian resource property" is defined to include various interests in oil and gas and mineral resources located in Canada. The cost of a Canadian resource property is either a Canadian oil and gas property expense or a Canadian development expense.

Paragraph (*g*) of the definition "Canadian resource property" describes any right or interest in any property described in any of paragraphs (*a*) to (*f*) of that definition, other than a right or interest that the taxpayer has by reason of being a beneficiary of a trust. Paragraph (*g*) of the definition is amended to clarify that a right or interest in any property described in paragraphs (*a*) to (*f*) of the definition, which is acquired after December 20, 2002, does not include any right or interest that the taxpayer may have by reason of being a member of a partnership.

Non-Arm's Length Partnerships

ITA
66(17)

Subsection 66(12.66) of the Act permits certain Canadian exploration expenses incurred in a particular calendar year to be treated as having been incurred at the end of the preceding calendar year ("look-back rule") for the purpose of the flow-through share rules. The look-back rule does not apply where the flow-through share subscriber and the renouncing corporation do not deal with each other at arm's length. This limitation prevents the look-back rule from being used to accelerate deductions in non-arm's length situations.

Subsection 66(17) of the Act defines the circumstances in which a non-arm's length relationship between a partnership and a renouncing corporation is considered to exist during the first 60 days ("look-back period") following the end of the calendar year in which the flow-through share agreement was made. Subsection 66(17) is amended to reflect the extension in the look-back period from 60 days to one year. This amendment generally applies to expenses incurred after 1996, except expenses incurred in January or February of 1997 in respect of an agreement made in 1995.

Clause 5

Canadian Exploration Expense

ITA
66.1(6)

Subsection 66.1(6) of the Act contains the definition "Canadian exploration expense" of a taxpayer.

Paragraph (*g*) of the definition "Canadian exploration expense" describes pre-production mining expenses. Paragraph (*g*) is amended to confirm, for greater certainty, that the term "production", which is the end point for incurring a pre-production expense, is a reference back to the preceding term "production in reasonable commercial quantities". Thus, this amendment confirms that otherwise qualifying expenses that are incurred prior to the new mine coming into production in reasonable commercial quantities will qualify as pre-production mining expenses. Pre-production mining expenses described in paragraph (*g*) in respect of certain minerals are eligible for the 10% pre-production mining expenditure tax credit applicable to expenses incurred after 2002.

New paragraph (*k*.2) of the definition "Canadian exploration expense" confirms, for greater certainty, that mining exploration expenses and pre-production expenses described in paragraph (*f*) or (*g*), other than clause (*f*)(ii), do not include any portion of the expenses that may reasonably be considered to have resulted in revenue earned by the taxpayer before the mineral resource or mine referred to in those paragraphs come into production in reasonable commercial quantities. This provision confirms that production revenue earned prior to the commencement of production in reasonable commercial quantities is to be netted out in computing Canadian exploration expense.

Clause 6

Canadian Development Expense

ITA
66.2(5)

Subsection 66.2(5) of the Act contains the definitions "Canadian development expense" and "cumulative Canadian development expense" of a taxpayer. The cost of property described in paragraph (*b*), (*e*) or (*f*) of the definition "Canadian resource property" in subsection

66(15) or any right to or interest in such property is referenced in paragraph (*e*) of the definition “Canadian development expense”. An amount in respect property described in paragraphs (*b*), (*e*) or (*f*) of the definition “Canadian resource property” is referenced in the description of F in the definition “cumulative Canadian development expense”.

As announced in the December 2002 Draft Technical Income Tax Amendments, paragraph (*e*) of the definition “Canadian development expense” and the description of F in the definition “cumulative Canadian development expense” are amended, applicable after December 20, 2002, as a consequence of changes to the definition “Canadian resource property”. Among other things, the amended definition “Canadian resource property” clarifies that a right or interest that the taxpayer has by reason of being a member of a partnership does not qualify as a Canadian resource property.

In addition, paragraph (*e*) of the definition “Canadian development expense” is amended to confirm, for greater certainty, that amounts paid for the preservation of a taxpayer’s rights in the property described in that paragraph will qualify as a Canadian development expense, unless specifically excepted at the end of the paragraph.

For taxation years that begin after 2006, the paragraph is further amended consequential upon the repeal of paragraph 18(1)(*m*).

Clause 7

Canadian Oil and Gas Property Expense

ITA
66.4(5)

Subsection 66.4(5) of the Act contains the definitions “Canadian oil and gas property expense” and “cumulative Canadian oil and gas property expense”. The cost of property described in paragraph (*a*), (*c*) or (*d*) of the definition “Canadian resource property” in subsection 66(15) or a right to or interest in such property is referenced in paragraph (*a*) of the definition “Canadian oil and gas property expense”. An amount in respect of property described in paragraphs (*a*), (*c*) or (*d*) of the definition “Canadian resource property” is referenced in the description of F in the definition “cumulative Canadian oil and gas property expense”.

As announced in the December 2002 Draft Technical Income Tax Amendments, paragraph (*a*) of the definition “Canadian oil and gas property expense” and the description of F in the definition “cumulative Canadian oil and gas property expense” are amended, applicable after December 20, 2002, as a consequence of changes to the definition “Canadian resource property”. The amended definition “Canadian resource property” clarifies that a right or interest that the taxpayer has by reason of being a member of a partnership does not qualify as a Canadian resource property.

In addition, paragraph (*a*) of the definition “Canadian oil and gas property expense” is amended to confirm, for greater certainty, that amounts paid for the preservation of a taxpayer’s rights in the property described in that paragraph will qualify as a Canadian oil and gas property expense, unless specifically excepted at the end of the paragraph.

For taxation years that begin after 2006, the paragraph is further amended consequential upon the repeal of paragraph 18(1)(*m*).

Clause 8

Inadequate Consideration

ITA
69

Section 69 of the Act provides a series of rules dealing primarily with transactions between non-arm’s length persons or between persons on non-arm’s length terms.

Disposition of Petroleum, etc.

ITA
69(6) - 69(10)

Subsections 69(6) to 69(10) of the Act are provisions designed to prevent the avoidance of paragraphs 12(1)(*o*) and 18(1)(*m*) of the Act. These subsections deem a taxpayer who disposes of, or acquires, production from an oil or a gas well or a mineral resource in Canada to the Crown (or an emanation of the Crown) at an amount other than its fair market value to have disposed of, or acquired, that production for its fair market value.

As announced in the December 2002 Draft Technical Income Tax Amendments, subsection 69(6) is amended, in the same manner as paragraphs 12(1)(*o*) and 18(1)(*m*) and effective after December 20, 2002, to remove the requirement that the production be disposed of by reason of "an obligation imposed by statute or a contractual obligation substituted for an obligation imposed by statute".

Subsections 69(6) to 69(10) are also repealed effective for taxation years that begin after 2006, consequential upon the repeal of paragraphs 12(1)(*o*) and 18(1)(*m*). For additional information, see the commentary to paragraphs 12(1)(*o*) and 18(1)(*m*).

Clause 9

Reimbursement by Taxpayer

ITA
80.2

Section 80.2 of the Act is a special rule which applies where a taxpayer reimburses another taxpayer in respect of a Crown resource royalty described in paragraphs 12(1)(*o*) or 18(1)(*m*). Where the reimbursing taxpayer is resident in Canada or carrying on business in Canada, that taxpayer is treated as not having made the reimbursement but is treated as having paid a Crown royalty described in paragraph 18(1)(*m*) equal to the amount of the reimbursement. In addition, the recipient of the reimbursement is treated as not having received it. As a consequence, the reimbursing taxpayer is denied a deduction under paragraph 18(1)(*m*) in respect of such reimbursement and the recipient of the reimbursement is not required to include the amount of such reimbursement in computing income.

Section 80.2 is repealed for taxation years that begin after 2006 consequential upon the repeal of paragraphs 12(1)(*o*) and 18(1)(*m*).

Clause 10

Partnerships and their Members

ITA
96(1)

Subsection 96(1) of the Act requires that the income earned and losses incurred by a partnership be calculated at the partnership level and be attributed to partners in accordance with their respective interests.

An exception to the general rule is provided in subparagraph 96(1)(*d*)(i) in respect of certain resource income inclusions and deductions, including those provided by paragraphs 12(1)(*z*.5) and 20(1)(*v*.1), which are recognized for the computation of income only at the partner level. Subparagraph 96(1)(*d*)(i) is amended applicable to taxation years that begin after 2006 to remove the references to paragraphs 12(1)(*z*.5) and 20(1)(*v*.1), consequential on the repeal of those provisions.

Clause 11

Trusts and their Beneficiaries

ITA
104(29)

Subsection 104(29) of the Act allows a trust to flow through to a beneficiary a reasonable share of “phantom income” realized at the trust level because of an inclusion of Crown royalties in the trust's income. The phantom income is calculated generally net of the trust's resource allowance deduction claimed under paragraph 20(l)(*v*.1) of the Act. In order to benefit from the application of subsection 104(29) in a taxation year, the trust must designate an amount, not exceeding the amount determined under subsection 104(29), in its return of income for that year.

As announced in the December 2002 Draft Technical Income Tax Amendments, subsection 104(29) is amended so that an amount designated by a trust in its return of income for a taxation year throughout which it was resident in Canada is deemed to have become payable, in the proportions that are designated by the trust in that return of income, by the trust to particular beneficiaries of the trust in the year if

- as required by paragraph 104(29)(*b*), the designated proportions are reasonable having regard to the shares of the trust-purpose income of the trust for the year included in computing the beneficiaries' incomes for the year, and
- the designated amount does not exceed the amount determined by the formula

$$(A - B) \times C/D.$$

The amounts described in the variables of this formula generally correspond with the amounts described in current paragraphs 104(29)(*a*) to (*d*). In some cases, the descriptions are modified to clarify their intended application. More particularly, variable A is the total of all amounts each of which is

- an amount that is not deductible in computing the trust's income for the year, but that would be deductible in computing that income if the Act were read without reference to paragraph 18(1)(*m*),
- an amount that is required by paragraph 12(1)(*o*) or by subsection 69(6) or (7) to be included in computing that income, or
- an amount that is required to be included in computing that income because of an amount designated under this subsection by another trust.

New subparagraph (iii) of the description of A ensures that, in circumstances involving two or more tiers of trusts, the phantom income deemed payable under subsection 104(29) by a particular trust to a beneficiary of the particular trust that is another trust can be further flowed through, where subsection 104(29) applies to the other trust, by the other trust to the other trust's beneficiaries.

Variable B of the formula is the total of all amounts each of which is:

- an amount that is deductible (otherwise than because of the membership of the trust in a partnership) under paragraph 20(1)(*v*.1) in computing the trust's income for the year, or
- an amount that is not included in computing that income, but that would be included in computing that income if the Act were read without reference to section 80.2.

Variable C of the formula is the total of all amounts each of which is a part of the trust's income for the year, computed without reference to the provisions of the Act (in subsection 104(29) referred to as the "trust-purpose income of the trust for the year"), that was payable in the year to a beneficiary of the trust, or that was required by subsection 105(2) of the Act to be included in computing the income of a beneficiary of the trust.

Variable D is the trust-purpose income of the trust for the year.

These amendments apply to trust taxation years that end after December 20, 2002.

Subsection 104(29) is repealed for trust taxation years that begin after 2006, consequential upon the repeal of paragraphs 12(1)(*o*) and 18(1)(*m*).

Clause 12

Corporate Tax Reductions

ITA
123.4

Section 123.4 of the Act provides a tax reduction to all corporations that earn full rate taxable income in the taxation year. The amount of the deduction is calculated by multiplying the corporation's general rate reduction percentage by the corporation's full rate taxable income for the year. The general rate reduction percentage is the percentage reduction available to the corporation for the particular calendar year (pro-rated based on the number of days of the taxation year that falls in each calendar year). A corporation's full rate taxable income is generally the amount of a corporation's income, which has not been

subject to reduction under a special measure in the Act, such as the small business deduction, M&P credit or the resource allowance.

ITA
123.4(1)

"full rate taxable income"

A corporation's full rate taxable income is generally the amount of a corporation's income, which has not been subject to reduction under a special measure in the Act, such as the small business deduction, M&P credit or the resource allowance. The definition full rate taxable income is amended for the 2003 and subsequent taxation years to remove the exclusion equal to 3 times the resource allowance.

For taxation years that end after 2002 and begin before 2007, this exclusion is replaced by an exclusion of the amount of the corporation's taxable resource income for the year as defined in new section 125.11. New section 125.11 contains a transitional resource tax reduction, which provides a reduction to tax payable for taxable resource income earned by a corporation.

For taxation years that begin after 2006, when the resource allowance (in paragraph 20(1)(*v*.1)) is fully phased-out, the reference to taxable resource income is repealed, with the result that income that would have been taxable resource income will be full rate taxable income after that date.

The amendment applies to the 2003 and subsequent taxation years.

Clause 13

Resource Tax Reduction

ITA
125.11

New section 125.11 gives effect to a reduction in the federal statutory corporate income tax rate on income earned from resource activities from 28 to 21 per cent by 2007, as announced in the Budget 2003 and the Department of Finance Technical Paper "Improving the Income Taxation of the Resource Sector in Canada" released March 3, 2003.

The federal corporate income tax rate reductions in respect of taxable resource income will be effective on January 1 of each year and will be pro-rated for corporations with taxation years that include days in more than one calendar year. The tax rate reduction begins with a 1% reduction in 2003 as follows:

	2003	**2004**	**2005**	**2006**	**After 2006**
Corporate income tax rate	27%	26%	25%	23%	21%

For taxation years that begin after 2006, resource income will be treated as full rate taxable income and will be subject to the general rate reduction rules. During the transitional period, 2003-06, this measure is accomplished by providing a deduction against the existing 28% rate for taxable resource income as defined. This deduction is provided in new section 125.11.

Definitions

ITA
125.11(1)

New subsection 125.11(1) of the Act contains two new definitions—taxable resource income and resource rate reduction percentage.

"taxable resource income"

A corporation's taxable resource income is calculated using the formula:

$$3(A/B) + C - D$$

Taxable resource income begins with income subject to the resource allowance, being 3(A/B), where A/B is 25% of the taxpayer's adjusted resource profits, as defined in Regulation 1210, for the taxation year. Specifically, A represents the deduction claimed by the taxpayer under paragraph 20(1)(*v*.1) of the Act. Since the deductible portion of the resource allowance is being reduced through the transitional period from 2003 to 2006, A is divided by B. B is pro-rated, based on the number of days in each calendar year, for taxation years that do not match the calendar year, and is the percentage of resource allowance permitted for deduction in the year, as follows:

	2003	2004	2005	2006	After 2006
B: Percentage of resource allowance deductible in computing income:	90	75	65	35	0

Added to this amount, for taxation years that begin after Announcement Date, is C, which is the total of all additions to the taxpayer's income in the year by virtue of negative resource pools (CEE, CDE, COGPE). Finally, any deductions from income on account of those resource pools claimed by the taxpayer in the year is deducted as D in computing taxable resource income. These latter refinements recognize that income inclusions and deductions based on resource pools are most appropriately streamed to resource income, but are not included in the computation of adjusted resource income in Regulation 1210.

"resource rate reduction percentage"

A corporation's "resource rate reduction percentage" for a taxation year is a percentage that is computed by reference to the number of days in a calendar year, or years, in which the taxation year falls. The resource rate reduction percentage for each of the years 2003-2007 is as follows:

	2003	2004	2005	2006	2007
Resource rate reduction percentage	1	2	3	5	7

For example, if a corporation's taxation year begins on July 1, 2003 and ends on June 30, 2004, the corporation's resource rate reduction percentage for the taxation year is approximately 1.5 %, computed as follows:

$$(184/365 \text{ x } 1\%) + (181/365 \text{ x } 2\%) = 0.5\% + 1.0\% = 1.5\%$$

Resource Deduction

ITA
125.11(2)

New subsection 125.11(2) of the Act allows a corporation a deduction from its tax otherwise payable under Part I for a taxation year. The amount of the deduction is calculated by multiplying the corporation's resource rate reduction percentage for the year by the corporation's taxable resource income for the year.

Since this deduction is provided in section 125.11, this deduction, like other deductions which are provided from sections 125 to 126, will not reduce:

(a) the tax subject to surtax under section 123.2, or

(b) "tax for the year otherwise payable under this Part" as defined in subsection 126(7), for the purposes of foreign tax credits, so as to ensure that the deduction for taxable resource income in Canada does not reduce the taxpayer's eligibility for foreign tax credits on income from outside Canada.

Clause 14

Investment Tax Credit

ITA
127(5)

Subsections 127(5) to (12.3) and (17) of the Act provide rules relating to the deductibility of a taxpayer's investment tax credit from tax otherwise payable under Part I.

As announced in Budget 2003 and the Department of Finance Technical Paper "Improving the Income Taxation of the Resource Sector in Canada" released March 3, 2003, this legislation proposes the introduction of a new 10-per-cent investment tax credit for qualifying mineral exploration expenses.

The new corporate mineral tax credit will apply in respect of eligible expenditures made in 2003, at a rate of 5 per cent. The rate will rise to 7 per cent in 2004, and will be fully phased in at a 10-per-cent rate in 2005. The new tax credit is available only to corporations that directly incur eligible expenses, and is not transferable under a flow-through share agreement, allocable by a trust or partnership, or refundable. The credit is otherwise subject to the usual provisions applicable to investment tax credits in the Act.

The new credit will apply to both grass roots exploration and pre-production development expenditures in Canada for qualifying minerals. These expenses are described in paragraphs (*f*) and (*g*) of the definition of "Canadian exploration expense" in subsection 66.1(6) of the Act. Otherwise eligible expenses incurred before a mine comes into production in reasonable commercial quantities will qualify for the new

credit. Qualifying minerals for the credit are diamonds, base or precious metals and industrial minerals that become base or precious metals through refining.

Investment Tax Credit

ITA
127(5)

Subsection 127(5) of the Act provides for the deduction of investment tax credits from a taxpayer's Part I tax otherwise payable for a taxation year. The term “investment tax credit” is defined in subsection 127(9) of the Act.

Subparagraph 127(5)(*a*)(i) provides that the taxpayer's investment tax credit at the end of the year in respect of property acquired before the end of the year or of the taxpayer's flow-through mining expenditure for the year or a preceding taxation year or of the taxpayer’s SR&ED qualified expenditure pool at the end of the year or of a preceding taxation year may be deducted in computing the taxpayer's tax payable for the year under Part I of the Act. For the 2003 and subsequent taxation years, subparagraph 127(5)(*a*)(i) is amended to ensure that the taxpayer's investment tax credit at the end of the year in respect of the taxpayer's pre-production mining expenditure for the year or a preceding taxation year may also be deducted in computing the taxpayer's tax payable for the year. The new term “pre-production mining expenditure” is added to the definitions in subsection 127(9).

Clause 127(5)(*a*)(ii)(A) provides that the taxpayer's investment tax credit at the end of the year in respect of property acquired in a subsequent taxation year or of the taxpayer's flow-through mining expenditure for a subsequent year or of the taxpayer's SR&ED qualified expenditure pool at the end of a subsequent taxation year may be deducted in computing the taxpayer's tax payable for the year. For the 2000 and subsequent taxation years, clause 127(5)(*a*)(ii)(A) is amended to ensure that the investment tax credit in respect of the taxpayer's pre-production mining expenditure for a subsequent year may also be deducted in computing the taxpayer's tax payable under Part I. The new term “pre-production mining expenditure” is added to the definitions in subsection 127(9).

Definitions

ITA
127(9)

Subsection 127(9) of the Act provides the various definitions used in the provisions relating to investment tax credits.

“investment tax credit”

The definition “investment tax credit” in subsection 127(9) of the Act provides for the determination of a taxpayer's investment tax credit at the end of a taxation year.

New paragraph (*a*.3) of the definition provides that, where the taxpayer is a taxable Canadian corporation, the specified percentage (5% for expenditures incurred in 2003, 7% for expenditures incurred in 2004 and 10% for expenditures incurred after 2004) of the taxpayer's pre-production mining expenditure at the end of a taxation year is added to the taxpayer's investment tax credit at the end of the year. The new expression “pre-production mining expenditure” is added to the definitions in subsection 127(9).

Paragraph (*c*) of the definition of “investment tax credit” provides for a three-year carryback and ten-year carryforward of unused investment tax credits in respect of which an amount is determined under paragraph (*a*), (*a*.1), (*a*.2) or (*b*) of that definition. Paragraph (*c*) of the definition is amended to add a reference to new paragraph (*a*.3) to ensure that amounts determined in respect of paragraph (*a*.3) have the same carryover period.

Paragraph (*e*.1) is amended to ensure that a taxpayer's investment tax credit for a taxation year is increased as a result of a repayment of government assistance, non-government assistance or a contract payment that reduced a qualified expenditure of the taxpayer that is a pre-production mining expenditure.

“pre-production mining expenditure”

The term “pre-production mining expenditure” is added to subsection 127(9) of the Act to define an expenditure that qualifies for the 10% investment tax credit, (phased in for 2003 and 2004 at 5% and 7% respectively) available to a taxpayer that is a taxable Canadian

corporation, as provided for in new paragraph (a.3) of the definition "investment tax credit" in subsection 127(9).

Generally, a pre-production mining expenditure is a grass roots exploration and pre-production development expenditure in Canada for qualifying minerals. These expenses are described in paragraphs (*f*) and (*g*) of the definition of "Canadian exploration expense" in subsection 66.1(6) of the Act. Those paragraphs require that the expenses be incurred before a new mine in the mineral resource comes into production in reasonable commercial quantities. Qualifying minerals for the credit are diamonds, base or precious metals and industrial minerals that become base or precious metals through refining.

The taxable Canadian corporation which claims an investment tax credit in respect of a pre-production mining expenditure must actually incur the expense, in order for the expense to qualify as a pre-production mining expenditure. Specifically, an expense which has been renounced to the taxable Canadian corporation under subsection 66(12.6) does not qualify as a pre-production mining expenditure. Further, the credit is not allocable by a partnership or trust. The credit is otherwise subject to the usual provisions applicable to investment tax credits in the Act, and is not refundable.

"specified percentage"

The definition "specified percentage" is amended to provided that the specified percentage at which an investment tax credit is earned in respect of a pre-production mining expenditure is 5% if the expenditure is incurred in 2003, 7% if the expenditure is incurred in 2004 and 10% if the expenditure is incurred after 2004.

Investment Tax Credit

ITA
127(11.1)

Subsection 127(11.1) of the Act sets out various rules for determining amounts to be included for the purpose of the definition "investment tax credit" in subsection 127(9) of the Act. These rules provide for the reduction of capital cost and qualified expenditures by certain amounts that qualify as assistance or contract payments.

New paragraph 127(11.1)(*c*.3) reduces a taxpayer's "pre-production mining expenditure" (as newly defined in subsection 127(9)) by the

amount of assistance that the taxpayer has received, is entitled to receive or can reasonably be expected to receive relating to expenses included in determining the taxpayer's pre-production mining expenditure.

The amendments to subsections 127(5), (9) and (11.1) apply to the 2003 and subsequent taxation years.

Clause 15

Tax in respect of certain Royalties etc., Paid by a Tax Exempt Person

ITA
208

Part XII of the Act imposes a penalty tax on tax-exempt persons in respect of certain royalties and related payments paid to the Crown by the tax-exempt person. The purpose of the tax is to discourage transactions between tax-exempt persons and taxable persons designed to shift the tax burden of Crown royalties from a taxable to a tax-exempt person, thereby resulting in a tax advantage since the tax-exempt person would not be affected by the treatment of Crown royalties under paragraphs 12(1)(*o*) and 18(1)(*m*).

Part XII of the Act is repealed for taxation years that begin after 2006 consequential upon the repeal of paragraphs 12(1)(*o*) and 18(1)(*m*).

Clause 16

Tax on Carved-out Income

ITA
209

Part XII.1 of the Act imposes a special tax on “carved-out income”. In general terms, the purpose of this tax is to discourage the use of tax-exempt persons and loss corporations for the holding of profitable resource property in respect of which profitable persons retain a substantial economic interest. “Carved-out income” is computed with reference to “carved-out property”, both of which are defined in subsection 209(1).

Definitions

ITA
209(1)

“carved-out income”

The special tax under Part XII.1 of the Act is computed on the carved-out income of a taxpayer from a carved-out property. The definition of carved-out income specifically denies certain deductions in computing such income. For example, no deductions are allowed for interest or other expenses provided under section 20 other than the resource allowance under paragraph 20(1)(*v*.1). The reference to paragraph 20(1)(*v*.1) is removed for taxation years that begin after 2006, consequential upon the repeal of that paragraph.

Clause 17

Additional Tax on Non-Resident Corporations

ITA
219

Section 219 of the Act imposes what is commonly known as the “branch tax” on non-resident corporations that carry on business in Canada.

Additional Tax

ITA
219(1)

The general structure of the branch tax base is as follows: the base is the amount, if any, by which the total of certain amounts, now listed in paragraphs 219(1)(*a*) through (*g*) of the Act, exceeds the total of other amounts, now listed in paragraphs 219(1)(*h*) through (*l*) of the Act. Included in the base (under paragraph (*c*)) is any amount deducted under paragraph 20(1)(*v*.1) of the Act. Excluded from the base (under paragraph (*k*)), is any amount included in income under paragraphs 12(1)(*o*) or prohibited from deduction under paragraph 18(1)(*m*).

Paragraphs 219(1)(*c*) and (*k*) are repealed for taxation years that begin after 2006 consequential upon the repeal of paragraphs 20(1)(*v*.1), 12(1)(*o*) and 18(1)(*m*). In addition paragraph (*e*) is amended as of that date to remove an internal reference to paragraph (*k*).

Clause 18

Interpretation

ITA
248

Section 248 of the Act defines a number of terms that apply for the purposes of the Act, and sets out various rules relating to the interpretation and application of various provisions of the Act.

Definitions

ITA
248(1)

"gross revenue"

The definition gross revenue defines gross revenue for certain purposes of the Act including the transfer pricing rules. The definition is amended for taxation years that begin after 2006 consequential upon the repeal of paragraph 12(1)(*o*), to remove the reference to that paragraph.

DRAFT REGULATIONS AMENDING THE *INCOME TAX REGULATIONS* (NATURAL RESOURCES)

1. (1) Subparagraph 1100(1)(*w*)(i) of the *Income Tax Regulations* is replaced by the following:

(i) the taxpayer's income for the year from the mine, before making any deduction under this paragraph, paragraph (*x*), (*y*) or (*ya*), section 65, 66, 66.1, 66.2 or 66.7 of the Act or section 29 of the *Income Tax Application Rules*, and

(2) Subparagraph 1100(1)(*x*)(i) of the Regulations is replaced by the following:

(i) the taxpayer's income for the year from the mines, before making any deduction under this paragraph, paragraph (*ya*), section 65, 66, 66.1, 66.2 or 66.7 of the Act or section 29 of the *Income Tax Application Rules*, and

(3) Subparagraph 1100(1)(*y*)(i) of the Regulations is replaced by the following:

(i) the taxpayer's income for the year from the mine, before making any deduction under this paragraph, paragraph (*x*) or (*ya*), section 65, 66, 66.1, 66.2 or 66.7 of the Act or section 29 of the *Income Tax Application Rules*, and

(4) Subparagraph 1100(1)(*ya*)(i) of the Regulations is replaced by the following:

(i) the taxpayer's income for the year from the mines, before making any deduction under this paragraph, section 65, 66, 66.1, 66.2 or 66.7 of the Act or section 29 of the *Income Tax Application Rules*, and

(5) Subsections (1) to (4) apply to taxation years that begin after 2006.

2. (1) Section 1104 of the Regulations is amended by adding the following after subsection (8):

(8.1) For greater certainty, for the purposes of paragraphs (*c*) and (*e*) of Class 28 and paragraph (*a*) of Class 41 in Schedule II, production means production in reasonable commercial quantities.

(2) Subsection (1) applies to property acquired after 1987.

3. (1) Paragraph 1204(3)(*b*) of the Regulations is replaced by the following:

(*b*) any income or loss arising because of the application of paragraph 12(1)(*z*.1) or (*z*.2) or section 107.3 of the Act; and

(2) Subsections 1204(4) and (5) of the Regulations are repealed.

(3) Subsection (1) applies to taxation years that begin after 2006.

(4) Subsection (2) applies to taxation years that begin after 2003.

4. (1) Paragraph (*b*) of the definition "production royalty" in subsection 1206(1) of the Regulations is replaced by the following:

(*b*) the taxpayer would, but for an exemption or allowance (other than a rate of nil) that is provided, pursuant to a statute, by a person referred to in subparagraph 18(1)(*m*)(i) of the Act, have a Crown royalty in respect of which paragraph (*a*) is applicable; (*redevance de production*)

(2) The definitions "exempt partnership", "production royalty" and "specified royalty" in subsection 1206(1) of the Regulations are repealed.

(3) Subsection 1206(8.1) of the Regulations is replaced by the following:

(8.1) For the purpose of paragraph (*a*) of the definition "qualified tertiary oil recovery project" in subsection (1), a specified royalty provision is deemed to apply as of a particular time if, at the particular time, unconditional approval for the specified royalty provision to apply at a time after the particular time is given by

(*a*) Her Majesty in right of Canada or of a province;

(*b*) an agent of her Majesty in right of Canada or of a province; or

(*c*) a corporation, a commission or an association that is controlled by Her Majesty in right of Canada or of a province or by an agent of Her Majesty in right of Canada or of a province.

(4) Subsection 1206(9) of the Regulations is repealed.

(5) Subsection (1) applies to royalties paid after December 20, 2002.

(6) Subsections (2) and (4) apply to taxation years that begin after 2006.

(7) Subsection (3) is deemed to have come into force on December 21, 2002.

5. (1) The portion of subsection 1210(1) of the Regulations before the formula is replaced by the following:

1210. (1) For the purpose of paragraph 20(1)(*v*.1) of the Act, the amount allowed to a taxpayer for a taxation year is the amount determined by the formula

(2) Section 1210 of the Regulations is repealed.

(3) Subsection (1) applies to taxation years that end after 2002 and begin before 2007.

(4) Subsection (2) applies to taxation years that begin after 2006.

6. (1) Section 1210.1 of the Regulations is repealed.

(2) Subsection (1) applies to taxation years that begin after 2006.

7. (1) Section 1211 of the Regulations is repealed.

(2) Subsection (1) applies to taxation years that begin after 2006.

8. (1) The definition "minerals" in subsection 3900(2) of the Regulations is repealed.

(2) Subsection (1) applies to taxation years that end after 2002.

9. (1) The definition "adjusted business income" in subsection 5203(1) of the Regulations is amended by adding the word "and" at

the end of paragraph (*b*), by striking out the word "and" at the end of paragraph (*c*) and by repealing paragraph (*d*).

(2) Paragraph 5203(2)(*a*) of the Regulations is replaced by the following:

(*a*) in computing its income for the year, an amount is deductible pursuant to any of sections 65 to 66.2 of the Act;

(3) Paragraphs 5203(4) of the Regulations is replaced by the following:

(4) For the purpose of subsection (1), “refund interest” means an amount that is received, or that becomes receivable, after March 6, 1996 from an authority (including a government or municipality) situated in Canada as a consequence of the overpayment of a tax that was not deductible under the Act in computing any taxpayer's income and that was imposed by an Act of Canada or a province or a bylaw of a municipality.

(4) Subsections (1) to (3) apply to taxation years that begin after 2006.

EXPLANATORY NOTES TO DRAFT REGULATIONS

Capital Cost Allowance — Mines

Clause 1

ITR
1100(1)(*w*), (*x*), (*y*), (*ya*)

Paragraphs 1100(1)(*w*) to (*ya*) of the Regulations allow an accelerated capital cost allowance, up to the amount of specified income from one or more mines, with respect to certain mining assets. For this purpose, a taxpayer's income is computed without reference to a taxpayer's resource allowance, resource loss or certain resource deductions.

Paragraphs 1100 (*w*) to (*ya*) are amended for taxation years that begin after 2006, to remove the reference to paragraphs 20(1)(*v*.1) (resource allowance) and 12(1)(*z*.5) (resource loss) of the Act, consequential upon the repeal of those paragraphs.

Clause 2

ITR
1104

Section 1104 of the Regulations provides interpretive rules for the purposes of the rules related to capital cost allowance in Part XI of the Regulations.

New subsection 1104(8) of the Regulations is added to confirm, for greater certainty, for property acquired after 1987, that the references to production from a mine in paragraphs (*c*) and (*e*) of Class 28 and paragraph (*a*) of Class 41, each of which deal with mining assets, are a reference back to production in reasonable commercial quantities in paragraph (*b*) of Class 28.

Resource Allowance

Clause 3

ITR
1204

Section 1204 of the Regulations contains the rules for determining a taxpayer's "resource profits" for a taxation year.

Subsection 1204(3) of the Regulations provides that any income or loss derived from transporting, transmitting or processing oil and gas, other than the processing of tar sands ore or heavy crude oil, is not taken into account in the determination of "resource profits".

Subsection 1204(3) is amended, applicable to taxation years after 2006 to remove the reference to a resource loss in paragraph 12(1)(*z*.5) of the Act, consequential on the repeal of that provision.

Subsections 1204(4) and (5) exclude royalties which are the subject of remission under the *Syncrude Remission Order* from the computation of resource profits. These paragraphs are repealed applicable to taxation years that begin after 2003, consequential upon the expiry of the *Syncrude Remission Order* on December 31, 2003.

Clause 4

ITR
1206

Section 1206(1) sets out interpretive rules relevant for the purposes of Part XII of the Regulations.

Subsection 1206(1) is amended, applicable to taxation years that begin after 2006 to repeal the definitions "exempt partnership", "production royalty" and "specified royalty", and subsection 1206(9), which applies to the definition "production royalty", consequential upon the repeal of section 1210 of the Regulations.

Certain amendments are also made to the definition "production royalty" and to subsection 1206(8.1), applicable after December 20, 2002 and consequential upon amendments to paragraph 18(1)(*m*) of the Act as of that date.

Clause 5

ITR
1210

Section 1210 of the Regulations provides for the calculation of a taxpayer's resource allowance for a taxation year, for the purposes of paragraph 20(1)(*v*.1) of the Act.

The opening words of subsection 1210(1) of the Regulations are amended applicable to taxation years that end after 2002, and begin before 2007, to provide that the amount of resource allowance deductible during the phase-out period from 2003 to 2006 will be as determined by the Act.

Section 1210 is repealed applicable to taxation years that begin after 2006, consequential upon the repeal of paragraph 20(1)(*v*.1) of the Act.

Clause 6

ITR
1210.1

Section 1210.1 of the Regulations provides the rules for computing a taxpayer's resource loss for a taxation year for the purposes of paragraph 12(1)(*z*.5) of the Act. Section 1210.1 is repealed applicable to taxation years after 2006, consequential upon the repeal of paragraph 12(1)(*z*.5) of the Act as of that date.

Clause 7

ITR
1211

Section 1211 of the Regulations prescribed amounts which are excluded from the application of paragraphs 12(1)(*o*) and 18(1)(*m*) of the Act. Section 1211 is repealed effective for taxation years that begin after 2006, consequential upon the repeal of paragraphs 12(1)(*o*) and 18(1)(*m*) of the Act as of that date.

Mining Taxes on Income

Clause 8

ITR
3900

Section 3900 of the Regulations provides the rules for determining the portion of mining taxes based on income which is deductible under paragraph 20(1)(*v*) of the Act.

Section 3900 applies to mining taxes on the mining of minerals, as defined. A restrictive definition of minerals is contained in subsection 3900(2). The definition "minerals" in subsection 3900 is repealed effective for taxation years that end after 2002, with the result that the broader definition "mineral" in the subsection 248(1) of the Act will apply for the purpose of section 3900 of the Regulations from that time. This amendment is relieving and consistent with the phase-out and repeal of paragraph 18(1)(*m*) of the Act.

Canadian Manufacturing and Processing Profits

Clause 9

ITR
5203

Section 5203 of the Regulations provides the rules for determining the resource income of a taxpayer for a taxation year for the purpose of determining the taxpayer's Canadian manufacturing and processing profits for the year under Part LII of the Regulations.

The definition of "adjusted business income" in subsection 5203(1) and paragraph 5203(2)(*a*) of the Regulations are amended consequential upon the repeal of paragraphs 12(1)(*z*.5) and 20(1)(*v*.1) of the Act for taxation years that being after 2006. Paragraphs 5203(4)(*b*) and (*c*) are repealed applicable to taxation years that begin after 2006, consequential upon the repeal of paragraphs 12(1)(*o*) and 18(1)(*m*) of the Act as of that date.